No. 15,247

IN THE

United States Court of Appeals

For the Ninth Circuit

LOUIS L. GOWANS and HELEN T. GOWANS, husband and wife,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONERS' REPLY BRIEF.

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INTRODUCTION.

Petitioners in their opening brief pointed out that the court below in its opinion relied upon its decision in *Crowell Land & Mineral Corp.,* 25 T.C. 223, in giving judgment for the Respondent upon the ground that the facts were indistinguishable. Petitioners also noted that the court below in its opinion also cited *Arthur S. Barker and Alberta C. Barker,* 24 T.C. 1160.

Petitioners then pointed out that the facts in the *Crowell* case were distinguishable from the facts in the present case (Br. pp. 10-12), as were the facts in *Barker* (Br. pp. 12, 13). The remainder of their

argument under point I in that brief (Br. pp. 14-24) was devoted to showing that the question for decision was whether or not they had retained an economic interest in the black sand under the 1945 agreement. As noted (Br. p. 14), it appeared that the decision in the *Crowell* case marked a departure from this time-honored test, for the Tax Court apparently held that a gain on a transaction involving minerals would be taxable as ordinary income in any case where the consideration was measured by the amounts removed.

It is significant to note that Respondent's brief filed herein does not attempt to support the decision below on its own basic ground, i.e., that the facts here are indistinguishable from those in the *Crowell* case, nor does it attempt to support *Crowell* as a matter of law or even cite or mention *Barker*. Instead, Respondent agrees that the question to be decided here is whether, under the terms of the agreements which are Exhibits V and XII, Petitioners retained an economic interest in the black sand which was the subject matter of those agreements.

ARGUMENT.

I. PETITIONERS RETAINED NO ECONOMIC INTEREST IN THE BLACK SAND UNDER THE 1945 AGREEMENT.

Respondent quotes from *Burton-Sutton Oil Company v. Commissioner,* 328 U.S. 25 (1946) at pages 34 and 35, where the Supreme Court stated:

> "It is the lessor's, lessee's or transferee's 'possibility of profit' from the use of his rights over

production, 'dependent solely upon the extraction and sale of the oil', which marks an economic interest in the oil."

Respondent also cites *Commissioner v. Southwest Exploration Co.,* 350 U.S. 308 (1956) at page 314 for the proposition that the existence of an economic interest requires two factors: (1) the acquisition by investment of an interest in the mineral in place, and (2) the securing of income derived from the extraction of the mineral. Respondent would perhaps have been somewhat fairer had he pointed out that the Supreme Court, further down on the same page, went on to say:

> "The second factor has been interpreted to mean that the taxpayer must look *solely* to the extraction of oil or gas for a return of his capital, and depletion has been denied where the payments were not dependent on product, *Helvering v. Elbe Oil Land Co.,* 303 U.S. 372, or where payments might have been made from a sale of any part of the fee interest as well as from production. *Anderson v. Helvering,* 310 U.S. 404."

The agreement of September 4, 1945, provided in part:

> "WHEREAS a portion of said two lots comprises an area of approximately 192,000 square feet, hereinafter called the 'Sand Area', as shown on a survey recently prepared by R. Towill; and
>
> WHEREAS Buyer has estimated that the Sand Area has within it approximately 250,000 cubic yards of black sand which the Buyer wishes to acquire for business purposes; . . .

The Buyer hereby covenants and agrees to and with the Seller, his heirs and assigns:

. . .

2. With the consent of the Commissioner of Public Lands first obtained, to purchase all the right, title and interest of the Seller in and to the Sand Area, and to pay the Seller therefor the purchase price of Fifty Cents (50¢) per square foot of land within the Sand Area according to said survey;

3. If the consent of the Commissioner of Public Lands to purchase the said interest of the Seller in and to the Sand Area cannot be obtained, but if permission to quarry and withdraw black sand from the Sand Area is obtained within a reasonable time after the date hereof, then the Buyer will quarry and haul away from the Sand Area approximately 250,000 cubic yards of black sand and will pay Seller therefor at the rate of Forty Cents (40¢) per cubic yard for all black sand so withdrawn . . .''

In connection with this agreement, the oral understanding of the parties that the payments under the agreement would be kept at an even pace must also be borne in mind. As is stipulated on pages 60 and 61 of the Record:

''In August, 1947, petitioner executed a note with the Bishop National Bank of Hawaii, promising to pay $70,000 in monthly installments of $1,050 each. In September, 1947, petitioners assigned to the Bishop National Bank of Hawaii their rights in the 1945 agreement with the corporation as security for the $70,000 note. Dray-

> ing Company was willing to make the payments to the bank at such uniform rate since the parties had an oral understanding that production would be kept at an even pace over the five-year period called for by the 1945 agreement."

In this context Petitioners contend that the payments to them were not dependent *solely* upon the *extraction* of the minerals but were part of the purchase price of the mineral in place.

In *Helvering v. Elbe Oil Land Co.,* 303 U.S. 372 (1938), the agreement between the parties called for the payment of some $2,000,000 to the seller, plus one-half of the net profits earned by the buyer from the oil and gas production on the property. The Supreme Court held that the agreement to pay one-half of the net profits was a personal covenant of the buyer and did not indicate that the seller had retained an economic interest in the property.

In *Anderson v. Helvering,* 310 U.S. 404 (1940), the agreement called for the payment of a total purchase price of $160,000, payable $50,000 in cash and $110,000 from one-half of the proceeds received by the buyer which might be derived from the oil and gas produced from the properties and/or from the sale of the fee title to any or all of the land conveyed. As in *Elbe Oil Land Co., supra,* the question arose as to whether the proceeds derived by the seller from the operation of the oil and gas property came from property in which the seller had retained an economic interest. The court held that the receipts did not. The

court stressed the fact that the additional payment might have come from the sale of the fee as well as from production of oil and gas, and stated that inasmuch as there could be no question in the case of an additional payment from the sale of the fee, it was obvious that when the additional payment was made as a result of production of oil and gas, no economic interest had been retained by the seller.

In the present case, as the testimony reveals, the primary interest of the parties was in a sale of the property (R. p. 97). As a result, the 1945 contract was drawn providing for the sale of 192,000 square feet of land from Petitioners to the Draying Company at a price of 50¢ per square foot—in other words, a purchase price of $96,000. In the alternative, the contract provides that the Draying Company will remove approximately 250,000 cubic yards of black sand, paying 40¢ per cubic yard, or $100,000.

In the construction of contracts the rule in Hawaii, as elsewhere, is that the cardinal purpose is to ascertain the intention of the parties, which is gathered not from particular words and phrases but from the agreement as a whole. This will be given effect if it can be done consistently with legal principles. *Hawaiian Pineapple Co. v. Saito,* 24 Hawaii 787 (1919). In the present case it is obvious from the alternative provisions of the agreement that what the parties were attempting to accomplish was a sale of the fee, if possible, and if not, to come as close to it as possible. The fact that the cash consideration moving from

the buyer to the sellers under either alternative was approximately the same, further bears out this intention of the parties. Obviously, therefore, under the agreement the Petitioners' possibility of profit was not dependent solely upon the extraction of the mineral. On the contrary, had the parties been able to obtain the consent of the Commissioner of Public Lands, the consideration would have been received from the sale of the fee.

The agreement provided for a payment of 40¢ per cubic yard of black sand removed during a five-year period. The testimony in the trial showed that there was no substantial uncertainty as to the amount of sand which would be removed under the agreement. The amount had been estimated by an engineer at 250,000 cubic yards before the agreement was entered into (R. p. 47). The agreement, Exhibit V, called for the removal of approximately 250,000 cubic yards and, in point of fact, 250,010 cubic yards were removed. It was the oral understanding of the parties that removal would be made at an even rate, and for that reason the Draying Company was willing to make payment substantially in advance of the rate of removal in order to permit Petitioners to meet their commitments to the bank which they had made in reliance on the oral understanding (R. pp. 60-61). The willingness of the Draying Company to make payments to the bank at a uniform rate, regardless of the sand removed, would seem to go far toward establishing that the agreement for payment in this case was in the nature of a personal covenant on the part of the

Draying Company. *Helvering v. Elbe Oil Land Co.*, 202 U.S. 372, 375 (1938). Moreover, since the payment to Petitioners might have derived from a sale of the fee rather than a sale of the minerals, there is a considerable resemblance to the situation in *Anderson v. Helvering,* 310 U.S. 404 (1940), and the reasoning of the Supreme Court in that case, in reaching the conclusion that no economic interest had been retained, would seem to be applicable here.

II. NO ECONOMIC INTEREST WAS RETAINED BY PETITIONERS UNDER THE 1950 AGREEMENT.

Under the agreement of May 19, 1950 (Ex. XII), the fact that Petitioners retained no economic interest in the sand is virtually indisputable. That agreement provided:

> "WHEREAS, the Buyer and the Sellers made and executed a certain agreement dated September 4, 1945, unrecorded, hereinafter called 'sand agreement', in which agreement the Buyer was given the right and has agreed to take approximately 250,000 cubic yards of black sand from a 4.433 acre area known as the Sand Area, being a portion of Lots 822 and 824 of the Makiki Round Top lots, Honolulu, T. H., being also a certain portion of L. P. Grants 11315 and 6815, area 4.433 acres, as more particularly described in a certain mortgage made by the Sellers to Bishop National Bank of Hawaii at Honolulu, dated August 21, 1947, recorded in the Hawaiian Registry of Conveyances in Book 2064, page 116, owned by the Sellers; and

WHEREAS, under said agreement the Buyer is authorized and is hereby authorized to enter upon and to take and remove therefrom black sand on payment of a royalty of forty cents (40¢) per cubic yard for black sand so removed, and is obligated to construct certain improvements on the said lands after removal of the black sand; and

WHEREAS, the said sand agreement as amended (by unrecorded amendment) provides for removal of the black sand and completion of certain improvements on or before July 1, 1951; and

WHEREAS, it has become essential in the interests of the Buyer's business and necessary to its business program in connection with its use of black sand that the Buyer have an extension of one year within which to exercise its rights, take black sand and to complete construction of the improvements provided for in the said sand agreement; and

WHEREAS, the Buyer still has the right and obligation to remove approximately 133,000 cubic yards of black sand upon royalty payment of forty cents (40¢) per cubic yard; and

WHEREAS, the Sellers desire to obtain a loan from the Bishop National Bank of Hawaii at Honolulu, hereinafter referred to as the 'Bank', in the amount of Forty-Eight Thousand Nine Hundred Sixty Dollars ($48,960.00); and

WHEREAS, the Sellers are willing to grant an extension of one year to enable the Buyer to exercise its rights and perform its obligations

under the sand agreement upon the following terms and conditions;

NOW THEREFORE, in consideration of the premises and of ONE DOLLAR ($1.00) each to the other paid, the receipt whereof is hereby acknowledged, and of the terms and agreements on the part of the Buyer and Sellers hereinafter set forth to be observed and performed, the Buyer and the Sellers do hereby mutually agree that the above mentioned sand agreement dated September 4, 1945, be and the same is hereby amended on the following terms and conditions:

(a) The time for completion of the provisions of the said sand agreement is hereby further extended for one year from July 1, 1951, to and including July 1, 1952;

(b) The Sellers will execute and deliver to the Bank their joint and several promissory note dated May 19, 1950, in the principal amount of $48,960.00 payable on demand after date with interest at the rate of three per cent (3%) per annum payable monthly on diminishing balances of principal, which note shall be endorsed by the Buyer;

(c) As further consideration for the one year extension, Buyer agrees to pay the interest on the unpaid balance of principal of said note accruing after the 19th day of May, 1950, and real property taxes attributable to the said 4.433 acre sand area for the period May 1, 1950 to June 30, 1952;

(d) Commencing June 20, 1950, all royalty payments for black sand removed from said 4.433 acre sand area are hereby irrevocably assigned

to the Bank as security for the repayment of said note and shall be made by the Buyer to the Bank at the rate of $2,040.00 per month and applied by the Bank on principal against the above mentioned note; and upon payment in full of said note all further payments of royalty shall be made to the Sellers;

(e) The Buyer will perform the Sellers' obligations to Yoshido H. Eguchi and Richard Fusao Hasegawa as set forth in a certain agreement between them and the Sellers dated the 1st day of July, 1946, recorded in Book 2091, page 44 in said Registry unless time for performance thereof is extended by agreement with said Yoshido H. Eguchi and Richard Fusao Hasegawa;

This agreement shall be binding on the parties hereto and their respective heirs, executors, administrators, successors and assigns.

IN WITNESS WHEREOF, the parties hereto have caused this agreement to be executed in duplicate the day and year first above written."

It will not do for Respondent to argue (Br. pp. 18, 19) that in so far as the taxpayers were concerned, they continued to be paid on the basis of production under this amended agreement, for this simply was not the case. Under the amended agreement, the taxpayers were to receive at once, through the device of a loan from the bank guaranteed by the Draying Company to be repaid by the Draying Company, the sum of $48,960. This was the equivalent of 40¢ per cubic yard on approximately 12/13ths of the sand still to be removed. The Draying Company under-

took to pay off the loan at the rate of $2,040 per month, regardless of production; to pay interest at the rate of 3% per annum on the balance of the loan; and to pay the real property taxes on the property during the period of the agreement. Obviously any argument that Petitioners' possibility of profit under the amended agreement was dependent *solely* upon the extraction of the mineral is completely untenable. Moreover, it cannot be doubted that the Draying Company's obligation under the amended agreement was a personal covenant.

III. RESPONDENT'S OTHER CONTENTIONS.

Respondent purports to rely (Br. p. 14) upon the decision of this court in *Usibelli v. Commissioner of Internal Revenue,* 229 F. 2d 539 (9th Cir. 1955), where this court reviewed at some length the various cases involving this question, particularly where coal deposits were at issue. As this court pointed out in that case, the question of whether a party to a mineral agreement has an economic interest in the minerals is one of difficulty, and various tests have been applied at various courts. This court stated:

> "Prime among these tests is whether the extractor looks for his compensation to the severance and sale of the mineral or whether his compensation is dependent upon the personal covenant of those with whom he has contracted." 229 F. 2d 544.

It is Petitioners' contention in the present case that under the 1945 agreement it was the intention of the

parties that the compensation of Petitioners should be dependent upon the personal covenant of the Draying Company. This intention is borne out by the statements of the parties and by their conduct in carrying out the agreement. With respect to the 1950 agreement, the fact that the compensation of Petitioners was dependent upon a personal covenant of the Draying Company is clear beyond dispute.

In the *Usibelli* case this court also pointed out that secondary factors included the amount of control which the contractor had over the amount and time of production and the disposal of surplus production, the length of the term of the contract, and whether or not the operator had the right to terminate the contract at will. As this court pointed out, a short-term contract terminable at will ordinarily vests no economic interest in the contractor, while a long-term fixed contract does vest such an interest. In this case the contract was for five years and the period was fixed. It was not terminable at will. These circumstances support the contention that no economic interest had been retained by Petitioners.

Respondent argues (Br. pp. 15, 16) that under the agreements the Draying Company would have no further right in the sand upon the termination of the period of limitation. We fail to find such a provision in either agreement. Moreover, this argument overlooks the fact that the agreements contemplated that, in addition to removing the sand, the Draying Company would do certain work on the land, leaving it in a condition fit for subdivision. Respondent states

(Br. p. 16) that taxpayers do not suggest what would happen to sand which was not removed and therefore the obligation to remove the sand was no more than the customary obligation to exploit a mineral lease. The answer to this is that the Draying Company had an obligation not only to remove the sand but to provide a right-of-way, put in a road, install other subdivision improvements and leave the land graded and ready for subdivision. In these circumstances, had the Draying Company failed to carry out its obligation to remove the sand, it would have been subject to a decree for specific performance compelling it to do so.

Respondent argues (Br. p. 16) that the presence of the condemnation clause in the 1945 agreement indicates the retention of an economic interest in the sand on the part of the sellers. Our answer is that the purpose of the condemnation clause was merely to provide a means of settling the rights of the parties in the event the agreement could not be carried out due to condemnation. It is true that such a clause is normally present in leases. It is equally true, as pointed out in Petitioners' opening brief (Br. pp. 18, 19) that many of the other clauses normally found in leases are not here present. Examples of these are covenants with regard to strip or waste, fencing, insurance, repair, right of entry for purposes of inspection, approval of plans for improvements, forfeiture, and maintenance of the premises in a clean and sanitary condition.

Respondent argues (Br. p. 17) that there was no provision for the Draying Company to pay taxes on the property which it is now asserted belongs to that company. We do not know just what taxes Respondent is referring to. There is no personal property tax in Hawaii, and as to the real property tax, the owner of the fee under the Hawaiian statutes is charged with the whole, regardless of what other interests there may be in the realty in question. Moreover, the statement that Petitioners paid the taxes themselves for all the years from 1946 through 1952, with a reference to Record pages 143-144, overlooks the fact that further along, on page 144, it was testified that pursuant to the 1950 agreement (Ex. XII) the Draying Company refunded to Petitioners the taxes from the date of that agreement until its expiration.

Respondent states that the expense of constructing the house on Lot 822 was treated as advance royalties rather than as a portion of a total purchase price (Br. p. 17), and then argues that this expense might be held to qualify as an initial payment (Br. p. 20).

Respondent criticizes the taxpayers (Br. p. 18) for attaching significance to the fact that payments were made in advance of sand actually removed, pointing out that in *Kittle v. Commissioner,* 21 T.C. 79, aff'd. 229 F. 2d 313 (9th Cir. 1956), advance or minimum payments were held to be consistent with the lease. The court below, however, based its decision upon *Crowell Land & Mineral Corp.,* 25 T.C. 223, which stated that "payment for deposits only as removed

and retention (or retransfer) of title to the balance are typical indicia of the existence of an economic interest." For this reason, the fact that in this case payments were not tied to removal is significant.

In both *Helvering v. Elbe Oil Land Co.,* 303 U.S. 372 (1938), and *Arthur N. Trembley v. Commissioner,* 1948 T.C. Mem. Dec. P-H, Vol. 17, par. 47,270, considerable weight was given by the courts to the factor of a large initial payment. In the present case it is therefore of some significance that in carrying out the 1945 contract a large advance payment in the form of a house costing in excess of $19,000 was made before production commenced, while under the 1950 contract Petitioners received 12/13ths of the total consideration at the outset and before the materials were removed. Respondent summarizes what he states to be the characteristics of this contract and which he states are common with the usual mineral lease. Among the characteristics he sets forth are the following:

> (1) Payment was to be made only as the sand was removed and at a rate fixed by the removal.

This is simply not true. It was not contemplated by the parties that payment was to be made only as the sand was removed, and payment was not so made in practice. Under the original agreement, over $19,000 was paid in the form of the construction of a home before there was any removal, and thereafter payments were made at the rate of $1,050 per month re-

gardless of the rate of removal. Under the amended contract, $48,960 was paid at the outset through the device of a bank loan, and the Draying Company obligated itself to repay this loan to the bank at the fixed rate of $2,040 per month regardless of the amount of sand removed.

(2) There was an obligation to exploit derived from the time limit with all rights to revert to the owner of the fee at the expiration of that time limit.

This again is simply not true. No such provision appears in either agreement. As we have pointed out, the agreements contemplated not only removal but other work on the land to render it fit for subdivision. Obviously there could not be any reversion of the sand involved in such a situation.

(3) The owners continued to pay all taxes on the entire property.

This again is incorrect. Under the 1950 agreement the obligation for the payment of taxes fell upon the Draying Company.

(4) There was no lump sum payment either made or agreed upon.

This again is not correct. The house was constructed in 1946 in advance of any removal. It was in fact a lump sum payment. Under the 1950 agreement $48,-960 was obtained at the outset by the Petitioners from the bank as a result of the agreement of the parties.

(5) Draying Company was not obligated to pay in all events any fixed total amount of any fixed installments.

This is not correct. Draying Company had an understanding that it would keep the payments uniform under the original agreement. Consequently, it assumed the obligation to make payments of $1,050 a month to the bank, regardless of production, from May of 1948 until the amended agreement was signed in 1950. It thereafter obligated itself in writing to make a payment of $2,040 per month to the bank, regardless of production.

(6) There was no deed of conveyance.

The answer to this is that no such instrument was necessary to accomplish the ends of the parties in question. The two agreements were sufficient, not only for the parties themselves but for the bank to make loans upon, as is borne out by the fact that such loans were made.

(7) There was no fixed description of the property, Draying Company being permitted to take nearly 100,000 of the 250,000 yards from below the level and to reject an equal amount of material from above the grade level.

Respondent apparently overlooks the fact that the agreement fixed the amount of black sand to be taken at approximately 250,000 yards, and that the grade levels to be established had also been fixed at that

time by obtaining preliminary approval of the subdivision from the City Planning Commission. When, in the course of excavation, it was discovered that not all of the material within the slice out of the mountain which was to be taken was black sand, naturally enough Draying Company took a small amount of black sand below the grade level and then filled the resulting hole with the unusable material quarried above the grade level.

The statement that there was no fixed description of the property to be taken is not in accord with the facts, since the property to be taken was described as approximately 250,000 cubic yards of black sand. The statement that approximately 100,000 cubic yards was taken below grade level is not borne out by the testimony. Mr. Bush testified (R. p. 102) that the hole which was dug was approximately 40 feet wide, 150 feet long and 70 feet deep. Such an excavation would contain 420,000 cubic feet, or approximately 15,556 cubic yards of material. Compared to the 250,010 cubic yards removed, this amount is certainly not substantial.

IV. PETITIONERS' ADDITIONAL CLAIM FOR A REFUND.

Lastly, Respondent argues that if Petitioners' additional claim for a refund is to be passed upon, a remand to the Tax Court is necessary (Br. p. 19). The question to be decided on this phase of the case is whether or not Petitioners received an initial payment upon the sale of the sand in question. If the sale was

consummated in 1945, they obviously did not. If, on the other hand, the sale was consummated when Petitioners obtained title to Lot 822 in 1946, the question is whether the building of the house by the Draying Company constituted an initial payment.

In contrast to his earlier argument that the payment by way of construction of the house was not an initial payment at all but merely an advance on royalties, Respondent argues (Br. p. 20) that it was an initial payment.

Petitioners submit their argument on this point in their opening brief was correct and that the record herein is sufficient to permit this court to decide the issue. They have, however, no objection to a remand if the court deems it necessary.

CONCLUSION.

For the reasons set forth above and in Petitioners' opening brief, it is respectfully submitted that the judgment of the Tax Court should be reversed and an order entered giving judgment in favor of Petitioners as prayed in their petition before the Tax Court.

Dated, Honolulu, Hawaii,
March 11, 1957.

Respectfully submitted,
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